Whole Loan Mortgage Backed Securities

Whole Loan Mortgage Backed Securities: High Desert Advisors recently made a purchase of this type of security for a client; the client has questions concerning this purchase which the Ordinary Millionaire provides answers to below. Some background first, however. Purchasing whole loan mortgage backed securities are not guaranteed by GNMA, FNMA, FHLMC agencies. The mortgage backed bond recently purchased is a Bank of America issued security with a 5.5% coupon, priced at 83.75. It will have an average life of about 7+ years and a yield that is in the 8+% area, depending on how quickly it pays off. Its current yield is 6.75%. It is rated AAA, but ratings are not particularly useful when evaluating a security of this type. What are more important are the underwriting criteria and the performance of the loans since inception.
Criteria of the investment:
> $25,000 purchase amount
> 6.5%+ yield to maturity
> highly rated (A or AA preferred, with yield reflective of rating)
> Maturity range of 2-6 years (Ordinary Millionaire expects high inflation in 3-4 years)

March 25, 2009 - The client's questions: "While we are talking about keeping risk under control, shouldn't we be limiting my concentration in mortgage-backed securities? This asset class is highly correlated across the economy, so wouldn't I be better off diversifying with more industrial bonds or discounted munis? Also, it's nice to see that these bonds have AAA ratings, but there was a lot of playing with the ratings in the past. how certain are we that they really deserve the ratings they quote?"

ANSWER: With regard to the mortgage backed securities, the assets you hold in your portfolio - GNMA, FNMA and FHLMC bonds - are different from the whole loan product that we recently purchased. The former have the guarantee of the U. S. Government. Whole loan product does not have this guarantee. That makes whole loan product a different animal when it comes to investing.

The analysis process is entirely different. For the former, we need only understand the prepayment characteristics in order to value the bond. For the latter, we must understand the underlying loans and make an estimate of the potential losses, as well as, and in addition to, analyzing the payment characteristics of the loans. This takes a much broader understanding of the underlying collateral (mortgage loans) in order to make that evaluation.

You have to treat whole loans differently. That being said, I have a pretty good background in this kind of security and am able to make those judgments with some credibility because I have experience in that industry.

Instead of paying par (100) for a security, we paid 83.75 (83.75% of par). That is a 16%+ discount from full value. More important, after analyzing this particular security, I am confident that these loans are likely to be fully amortized with no losses and with payment in full at par. If it repays sooner rather than over a longer period of time, this security will earn much more than the projected yield.

Because whole loan securities do not have a government guarantee, they must be treated differently in your portfolio. There is potential risk to capital, as you suggest. It would not be wise to concentrate too much money in this type of security, much less in a single issue like this one.

As to diversification, I consider this a diversified asset from those we have purchased for your account in the past. Recently, we bought Caterpillar bonds. I also showed you a couple of bonds that you did not like because they were financial companies. For what it is worth, I bought those bonds for other accounts because I like yields that are grater than 6%, for a period of three years, and I am very comfortable with a 3-year investment in either Goldman Sachs or Morgan Stanley, particularly now that they have become bank holding companies and fall under the regulatory oversight of the Federal Reserve.

As to your ratings question, there are real problems with trying to compare mortgage backed bonds to corporate bonds. As of now there is only one rating system, and the extension of this rating system to MBS's is problematic. This issue presents very difficult problems for the Accounting Standards Board (FASB). A new rating standard must be developed for mortgage backed securities. This is under construction and will be forthcoming sometime in the not too distant future, I believe.

The AAA rating for this security is not trustworthy today because of these issues. In order to buy a whole loan security, it is necessary to fully understand (as much as is feasible) the potential risks of each different security. I have made a positive judgment on the security we bought today. I would not rate it AAA, but I would certainly classify it as investment grade quality, and my sense is that it is at least as good a quality as, say, the Caterpillar bond we bought for your account.

Your questions are good ones. I hope I have provided useful answers.